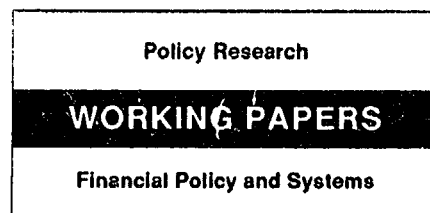


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# Policy Issues in Financial Regulation

Dimitri Vittas

The 1980s were a decade of extensive regulatory reform. Macroeconomic and allocative controls that inhibit competition, innovation, and efficiency were "out." Prudential and other controls that promote stability and fairness were "in." The relative costs and benefits of universal banks and financial groups remain a subject of controversy.

This paper — a product of the Financial Policy and Systems Division, Country Economics Department — is the introductory chapter of a forthcoming Economic Development Institute book on financial regulation. It reviews and summarizes several papers that have already been issued as World Bank Policy Research Working Papers. Copies of this paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Wilai Pitayatonakarn, room N9-003, extension 37666 (May 1992, 38 pages).

Dimitri Vittas summarizes the findings of a forthcoming book on financial regulation that examines the policy issues of financial regulation and reviews the experiences of both developed and developing countries. He stresses the following ten points:

- The 1980s were not a decade of deregulation, but a period of extensive regulatory reform. There was decreased reliance on economic regulations that inhibit competition, innovation, and efficiency — but increased emphasis on prudential and other regulations that promote stability and fairness.
- There is now widespread consensus on the need for market mechanisms for monetary and credit control and for allocating scarce financial resources.
- What the best speed and sequence of financial reform are remains an open question. The contrasting experiences of Japan and Chile support a cautious, gradual approach; Indonesia's experience suggests that several paths of reform may work.
- There is strong consensus on the importance of prudential, organizational, and protective controls, and especially on the need for capital adequacy and for strong banking supervision.
- There is ample recognition of the importance of speedy and decisive intervention to prevent insolvent institutions from magnifying losses and infecting the rest of the financial system.
- The role of deposit insurance is still unclear. It is instrumental in protecting small savers, but otherwise its role in preventing bank runs, promoting competition, or stimulating better regulatory mechanisms is open to serious objections.
- The regulatory issues of nonbank financial intermediaries are similar to those of banks. For life insurance companies, price and product controls — which inhibit competition — are being replaced by solvency controls. In addition, the use of insurance (and pension) funds for financing large public sector debts at below-market yields is being replaced by investment rules that emphasize safety and profitability.
- The most controversial type of control is still structural controls that impose geographic or functional limits on the activities of financial institutions. There is a worldwide trend in favor of universal banking and even in favor of close links between banks and insurance, but less support for close links between banks and industrial companies.
- Universal institutions pose a serious challenge to regulators and supervisors. Countries with weak supervisory agencies would be well advised to promote simpler and more transparent structures.
- There is considerable controversy about the desirability and benefits of universal banking. Many analysts emphasize the difficulties of regulation by function and of relying on rules of conduct for overcoming excessive risk taking, conflicts of interest, and the abuse of privileged information. These analysts favor structural controls that limit the scope for fraud and mismanagement. But other analysts argue that the threat of regulation, considerations of reputation, and provisions for legal redress against offending institutions would be effective in policing universal institutions.

Vittas concludes by noting that most Anglo-American and Scandinavian countries currently suffer from the consequences of excessive and uncritical expansion of credit as well as from widespread mismanagement and a significant amount of fraud. He argues that if financial problems were to persist, the case for imposing portfolio and growth limits for prudential purposes might merit detailed consideration.

The Policy Research Working Paper Series disseminates the findings of work under way in the Bank. An objective of the series is to get these findings out quickly, even if presentations are less than fully polished. The findings, interpretations, and conclusions in these papers do not necessarily represent official Bank policy.

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## FOREWORD

This paper is the introductory chapter of a forthcoming EDI book on financial regulation. It reviews and summarizes the following papers, some of which have already been issued as World Bank PRE Working Papers.

**Long, Millard and Dimitri Vittas.** Financial Regulation: Changing the Rules of the Game, World Bank, WPS 803, November 1991

**Vittas, Dimitri.** The Impact of Regulation on Financial Intermediation, World Bank, WPS 746, August 1991

**Horiuchi, Akiyoshi.** Financial Liberalization: The Case of Japan, World Bank, EDI and CECFP, mimeo.

**Cole, David and Betty Slade.** Indonesian Financial Development: A Different Sequencing?, World Bank, EDI and CECFP, mimeo.

**Cortes-Douglas, Hernan.** Financial Reform in Chile: Lessons in Regulation and Deregulation, World Bank, EDI and CECFP, mimeo.

**Sheng, Andrew.** Bank Restructuring in Malaysia, 1985-88, World Bank, PRE WPS 54, September 1989.

**Solheim, Jon A.** The Norwegian Experience with Financial Liberalization and Banking Problems, World Bank, EDI and CECFP, mimeo.

**White, Lawrence J.** The U.S Savings-and-Loan Debacle: Some Lessons for the Regulation of Financial Institutions, World Bank, EDI and CECFP, mimeo.

**Polizatto, Vincent P.** Prudential Regulation and Banking Supervision, World Bank, PRE WPS 340, January 1990.

**Talley, Samuel H. and Ignacio Mas.** The Role of Deposit Insurance, World Bank, EDI and CECFP, mimeo.

**Rabe, Thomas.** Life Insurance Regulation in the United Kingdom and Germany, World Bank, EDI and CECFP, mimeo.

**Freedman, Charles.** Universal Banking: The Canadian View, World Bank, EDI and CECFP, mimeo.

**Draghi, Mario.** The Case For and Against Financial Conglomerate Groups: The Italian Debate on the Eve of the European Banking Integration, World Bank, EDI and CECFP, mimeo.

**Talley, Samuel H.** Bank Holding Companies - A Better Structure for Conducting Universal Banking?, World Bank, PRE WPS 663, May 1991.

## **Introduction**

The 1980s have witnessed major and fundamental changes in the scope and orientation of financial regulation. Governments in both developed and developing countries have engaged in an extensive rewriting of the rules of the game that govern the operations of financial institutions and markets. Credit and interest rate controls as well as restrictions on new entry and on the permissible activities of financial institutions have been removed or substantially relaxed. In their place, governments have established prudential and investor protection regulations that aim at safeguarding the soundness of the financial system and protecting the interests of users of financial services, especially the nonprofessional investors.

Regulatory reform has been associated with--in many cases it has been prompted by--major structural changes and innovations in financial markets. In many high income countries, there is a clear trend towards universal banking and a growing integration of banking and securities business. Integrated financial systems raise issues in financial regulation that cut across banking and nonbanking markets. Two major issues regard the structure of regulation and the role of market forces in monitoring and controlling the performance of individual institutions.

In developing countries, the dominant position of commercial banks, which are often state-owned, has been challenged by the creation of non-bank financial intermediaries and the emergence of more active securities markets. This raises regulatory issues that go beyond traditional concerns with the performance and standing of commercial and development banks. However, commercial banks are likely to continue to play a central part in the financial systems of developing countries so that issues in bank regulation, including the role of prudential controls and supervision and the resolution of banking crises, will continue to be of prime concern to policy makers.

Whether financial systems are dominated by commercial banks or are based on a more diversified structure, an important ingredient that shapes the functioning and efficiency of financial institutions is the stance of macrofinancial policy. Failure to maintain macroeconomic stability has deleterious effects on the operations of financial institutions. This is true both at times of excessive (inflationary) expansion and at times of collective contractions. Moreover, the pursuit of macroeconomic and financial stability may come into conflict with the process of financial innovation.

A related issue concerns the pace and implications of financial reform and the transition from a system subject to financial repression, limited competition and directed allocation of resources to one based on competitive market forces operating in a stable and well structured framework. The importance of sustaining macroeconomic and financial stability while implementing financial reform is now amply recognized by policy makers. However, questions regarding the pace and sequencing of reforms are still difficult to answer.

This volume of papers explores recent developments in financial regulation and addresses some of the issues highlighted above. The volume is divided into six parts: (i) introduction and overview; (ii) general issues in regulatory reform; (iii) issues in financial liberalization; (iv) banking crises and restructuring; (v) regulatory framework for banks and other financial institutions; and (vi) regulatory issues in integrated financial systems.

This introductory chapter provides an overview and summary of the papers that follow. Its purpose is to highlight the main issues addressed in each chapter and draw together the main lessons that emerge from the experience of different countries.

## **General Issues in Regulatory Reform**

### **Re-Writing the Rules of the Game**

In the first paper on general issues in regulatory reform, **Millard Long** and **Dimitri Vittas** stress that the 1980s was not a decade of financial deregulation but a period when the rules of the game were substantially re-written.

Long and Vittas note that the repressive regulations of the post World War II period were motivated by widespread dissatisfaction with the functioning and structure of the financial systems inherited from the colonial era and the Great Depression. Governments used finance as a tool of economic and industrial development by taking banks under public control, directing institutions to lend to selected industries on subsidized terms and keeping interest rates low, usually below the rate of inflation. Although the policies met some of the government objectives, they failed to create robust financial systems. With the onset of the debt crisis in the 1980s and the ensuing economic recessions, firms in most developing countries, especially in Africa, Eastern Europe and Latin America, were unable (or unwilling) to service their debts. Financial institutions became decapitalized and technically insolvent.

The failure of the traditional model of economic development fed disillusionment with government intervention in resource allocation. This has been reinforced by the recent collapse of centrally planned economies in Eastern Europe, the former Soviet Union and other parts of the world. As a result, there is now growing emphasis on private sector development as an engine of stable and sustainable growth. However, to develop financial systems that can finance their private sectors efficiently, countries need to restore their financial institutions to vitality, achieve and sustain macroeconomic stability and build their financial infrastructure by developing modern and effective information, legal and regulatory systems.

In using regulatory reform for shaping the structure of the financial system, policy makers can choose between alternative models. The historical distinction between bank-based and securities-based systems is less relevant these days as internally generated funds have become the primary source of corporate finance in most countries. An important differentiation still exists between relationship-based and transaction-based systems, but in developing countries policy makers would be well advised to encourage, at least initially, the creation of simple structures that are more transparent and easier to manage and supervise.

Long and Vittas suggest three criteria for evaluating financial regulation and structure: stability, efficiency and fairness<sup>1</sup>. Stability is important because unstable financial systems

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<sup>1</sup> Key and Scott (1991) develop a "banking matrix" that lists four policy goals of regulation: promotion of competitive markets, ensuring safety and soundness, avoidance of systemic risk and providing consumer protection. These are very similar to the three criteria

have a large adverse impact on economic activity. Financial stability can be enhanced by increasing capital requirements and strengthening financial supervision. But the stability of the financial system is also affected by its structure. Systems with "narrow" banks or "non-par" banks would be exposed to lower systemic risks.

The relationship between structure and efficiency is also complex. In the research literature the issues of economies of scale and scope in finance still seem unresolved. In developed countries, there is growing concentration and a spread of universal banking, suggesting economies of both scale and scope. Moreover, available evidence suggests that concentrated banking systems tend to have lower margins and operating costs as well as higher profits. But in developing countries, large banks tend to be inefficient. Their size is the result of controls and restrictions on competition and entry rather than superior efficiency. Allowing universal banking might exacerbate the dominant position of large banks with adverse effects on competition and efficiency.

Fairness covers many issues ranging from the protection of users of financial services to the creation of a level playing field for competing institutions and the resolution of problems caused by potential conflicts of interest. Fairness can be more easily achieved in systems with simple structures, but limits on the permissible range of activities of different types of institutions might undermine efficiency and, to a lesser extent, stability.

Long and Vittas emphasize that there are tradeoffs between the three criteria and suggest that there are no general answers to the questions posed by these tradeoffs. Answers must be sought in the context of particular countries on a case-by-case basis, although it is clear that extreme solutions that promote one criterion and totally disregard the others would not be optimal.

#### The Rationale, Objectives and Impact of Financial Regulation

The impact of regulation on financial structure is the subject of the second paper in this volume. Dimitri Vittas notes that regulation is perhaps the most important determinant of differences in financial structure exhibited by countries at a similar level of development and with access to common technologies. He also notes that the main rationale for financial

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of stability, efficiency and fairness.



regulation is the existence of market failure arising from externalities, market power and information problems (Kay and Vickers, 1988). Market failure is a necessary but not sufficient condition for regulation. The other condition is that regulation can correct market failure in an effective and efficient way. Much of the debate among alternative theories of regulation is about the cost and effectiveness of regulation rather than about its rationale.

Externalities include the risk of systemic failure (the risk of failure of one or more banks as a result of the actual or threatened failure of another), the infection effect (the general lowering of standards and prices caused by excessive competition) and network effects (the costs and benefits of linking together competing institutions to a common network). Other externalities include the achievement of macrostability (to avoid distortions in relative prices, incentives and expectations caused by high and volatile inflation) and the enhancement of the allocative efficiency of the financial system (to ensure the financing of projects and sectors, including small firms, with high dynamic efficiency gains). Concern about market power stems from the fear that dominant firms may undermine both allocative and dynamic efficiency (the former by charging high prices and earning excessive profits, the latter by avoiding competitive pressures). Finally, information problems arise from poor price and product information, from the free rider problem, and from informational asymmetries between the suppliers and users of financial services.

Vittas classifies financial regulations by their primary objective into six types: macroeconomic, allocative, structural, prudential, organizational, and protective. There is a certain correspondence between types of regulations and different rationales, although most regulations have effects that cut across different purposes. For instance, bank-specific credit ceilings are mainly applied for macroeconomic purposes but they also restrain banks from engaging in an uncontrolled and imprudent expansion of credit and thus serve fulfil a prudential objective.

Historical experience suggests that macroeconomic and allocative controls tend to be ineffective and inefficient. Macroeconomic controls are often justified by the paramount importance of controlling the expansion of credit and maintaining price stability and by the absence of active money and government bond markets that would allow the use of market-based mechanisms for monetary and credit control. But rather than relying on direct controls that stifle competition and inhibit innovation, governments should stimulate the development of money and bond markets.

Allocative controls are motivated by the need to finance sectors with dynamic efficiency gains but limited or insufficient access to credit facilities. Allocative controls are a prime example of the argument that market failure is a necessary but not sufficient condition for regulation. Because of poor design and deficient implementation, especially inadequate monitoring of privileged borrowers, allocative credit controls have failed in most countries to achieve their objectives.

In contrast to macroeconomic and allocative controls, prudential, organizational and protective controls are necessary because financial systems suffer from moral hazard, adverse selection and the free rider problem, are susceptible to imprudent and fraudulent behavior, and are prone to instability and crisis. The main policy issue with regard to these types of controls is how to devise measures that are effective without undermining competition and innovation in the financial system.

Structural controls are the most controversial type of financial regulation. Their main objectives are to prevent excessive concentration of market power, limit the potential for conflicts of interest and discourage financial institutions from assuming excessive risks by expanding into areas that are remote from their main focus of operations and expertise. But structural controls are often motivated by political considerations, such as preserving the dominant position of domestic banks or protecting the turfs of different types of financial institutions.

Structural controls may cause a fragmentation of the financial system into a large number of small institutions with limited capital resources. This is likely to increase both the risk of systemic failure and the risk of infection. Perverse and politically motivated structural controls may undermine the effectiveness of other types of financial regulation.

Vittas emphasizes the importance of creating a sound and robust financial constitution that encourages financial institutions to build adequate capital reserves, diversify their risks and exploit potential economies of scale and scope. Such a constitution should be complemented with a system of effective supervision, short-term financial accommodation, long-term financial restructuring and financial compensation for customers of failed institutions. Deposit insurance, which is a special case of financial compensation, has a role to play in protecting the interests of small depositors, but if it is used to prevent runs on fragmented and fragile institutions, it is likely to distort incentives and suffer from problems

of moral hazard. A sound financial constitution, which avoids the fragmentation and segmentation of the financial system and discourages the continuing existence of fragile and under-capitalized institutions, would contribute to higher efficiency and stability and would avoid the costs of later interventions.

For most of the post World War II period, financial regulation in developing countries emphasized macroeconomic, allocative and structural objectives, while prudential, organizational and protective controls were conspicuous by their absence. A similar pattern was observed in most developed countries, although some emphasis was placed on prudential considerations in a few countries. Among developed countries, the United States stands out for its limited use of macroeconomic and allocative controls but extensive reliance on structural controls. Vittas maintains that many of the problems facing the U.S. financial system, such as the fragmented and fragile banking system, the financial crisis of the thrift industry, and the segmentation of the financial system, can be attributed to the adverse effects of structural regulations.

The fragmentation of the banking and thrift industries reflects a strong tradition of localism in American banking and an emphasis on populist policies motivated by fear of the concentration of power that large banks from out-of-state centers might acquire<sup>2</sup>. Vittas argues that economists have undermined potential support for consolidation of the banking and thrift industries by downplaying the potential economies of scale and scope of large banks. By focussing on the production side of banking services and neglecting potential economies in risk and marketing, they have largely failed to establish a strong case for greater consolidation<sup>3</sup>.

Regulatory reform in both developed and developing countries has been motivated by macroeconomic pressures and by rapid technological advances. Reform has been easier to implement where it could be accomplished without the need for cumbersome legislative

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<sup>2</sup> This view is echoed by White (see Chapter 9) and Polizatto (Chapter 10).

<sup>3</sup> In recent years, academic and bank economists have started to underscore the regulation-induced fragmentation and fragility of the US banking system (see, for instance, Berlin et al 1991, Berger and Humphrey 1990, Shaffer 1989 and Udell 1990). But these views have yet to generate wide political support for an extensive consolidation of the industry. If anything, opposition to banking consolidation is still quite strong, not only among political circles, but also among bank and academic economists.

changes. In fact, the threat of regulation, when prompt action is feasible, may have been as effective as actual regulation in discouraging excesses and preventing abuses. Vittas concludes by emphasizing that political leadership has an important role to play in promoting higher stability, efficiency and fairness in the financial system by removing distortionary, inefficient and ineffective regulations and replacing them with regulations that are as far as possible neutral between different financial intermediaries and markets.

## **Issues in Financial Liberalization**

### **Financial Liberalization in Japan**

Japan represents an interesting example of a country with initially extensive financial regulations (covering credit ceilings, interest rate controls, directed credit programs, geographic and sectoral segmentation, and branching restrictions) that was able to achieve a high rate of growth and then proceeded to deregulate its financial system in a gradual and controlled fashion. Akiyoshi Horiuchi analyzes the process of financial liberalization in Japan since the end of World War II. He first examines the relationship between financial regulation and economic growth during the high growth era, specifically the period from 1960 to the early 1970s. He then considers the financial liberalization that started in the mid-1970s. Horiuchi emphasizes that financial liberalization was induced by the structural changes caused by the achievement of high growth and that it was not a cause but rather a consequence of economic development in Japan.

Horiuchi notes that the Japanese financial system was under comprehensive regulation during the high growth era, but argues that some regulations were circumvented, for instance loan rates were effectively raised through the use of compensating balances. He also argues that the level of interest rates was not low in either nominal or real terms<sup>4</sup>. However, an important feature of the regulatory regime was the support of high profits for banks and other financial institutions and the general discrimination against consumer credit and housing finance.

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<sup>4</sup> This argument is based on the use of producer price inflation for calculating the real rate of interest. If the consumer price index is used instead, then the real rate of interest was rather low in Japan as Horiuchi acknowledges.

The success of the Japanese authorities in containing inflation and maintaining macroeconomic stability is credited as the main reason why financial repression did not prevent the achievement of economic growth. Horiuchi attributes this to the constraint imposed by the balance of payments and the decision of the Japanese authorities to discourage foreign capital inflows to relieve this constraint. Controls on capital inflows were also motivated by the desire to "protect" domestic industries from falling under foreign ownership. He lists electrical appliances, radio sets, TV sets, plate glass, cameras, synthetic fibers, laundries, and shipbuilding as benefitting from such protection. He maintains that the controls on foreign capital inflows reinforced the dominant role played by Japanese banks in corporate finance.

The role of banks was also shaped by the weakness and underdevelopment of the securities markets. There was no money or bond market so that nonfinancial corporations and households could not place their financial savings in uncontrolled instruments. The corporate bond market was prevented from playing a more active part by the Kisaikai, an association of trust banks and securities companies that imposed unfavorable conditions on the issue of corporate bonds. Finally, the equity market suffered from structural weaknesses, such as the issue of new shares at par and the sharp decline of equity prices in the mid-1960s that caused financial distress among securities firms and scared investors away from the securities markets.

Horiuchi argues that in this context the banks became the main agents of financial intermediation. Their ability to allocate resources efficiently was facilitated by the development of close relationships with major borrowers. In fact, it could be argued that the close links between banks and industry proved more effective in overcoming problems of asymmetric information and free riding than has been the case in countries with active and well developed securities markets.

Horiuchi concludes his analysis of financial regulation during the high growth era by emphasizing that the role of government financial institutions in stimulating economic growth is exaggerated by many commentators<sup>5</sup>. In his view (as in the opinion of several other leading Japanese economists, such as Aoki, Komiya and Teranishi), government institutions

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<sup>5</sup> A detailed discussion of different views on the effectiveness of credit policies in Japan and on the role of government financial institutions is contained in Vittas and Wang (1991).

mainly provided financial support to declining industries, such as coal mining and shipping. The rapidly growing dynamic sectors were mainly financed by private financial institutions, although government financial institutions may have played an important role by conveying valuable signals about the government's industrial policy to the private sector.

The structural changes that occurred after the oil crisis in 1973 included a big increase in government borrowing, a sharp decline in the demand for funds for industrial investment and a growing internationalization of the Japanese economy. A landmark in the process of liberalization, especially as it affected wholesale and corporate financial services, was the relaxation of foreign exchange controls in 1980. The rapidly growing government debt forced the authorities to encourage the development of a modern and efficient bond market. This provided alternative instruments for the financial savings of both nonfinancial corporations and households. Interest rate controls on large deposits and restrictions on new deposit instruments were then relaxed. The large corporations were able to raise funds on the domestic and international capital markets and stimulated the deregulation and modernization of the corporate bond and equity markets. Japanese banks expanded their operations in overseas markets and this led to growing international pressures for opening the domestic markets to foreign entry and competition.

Horiuchi identifies three issues as meriting close policy consideration: the need to modify the safety net in the financial system to protect small investors and prevent bank panics; the need to create a robust system of regulation and supervision of the securities markets, including regulations on insider trading and promotion of credit rating agencies; and the need to increase the effectiveness of anti-trust legislation. He concludes his paper by reiterating that high growth in Japan was achieved without a flexible market-oriented financial system, but the structural changes of the post-high-growth era stimulated the gradual liberalization that has been under way since the early 1970s.

#### Financial Liberalization in Indonesia

In contrast to Japan, which maintained a closed capital account throughout its high growth era and proceeded to liberalize its controls on capital flows on a very gradual and cautious basis, Indonesia provides an example of substantial deregulation and financial sector development in the context of a very open foreign exchange market. David Cole and Betty Slade review the Indonesian experience between the mid-1960s and the late 1980s. They

stress that contrary to the conventional wisdom that the capital account should be opened only after domestic investment, trade and financial reforms are first implemented, Indonesia removed all foreign capital controls when its foreign exchange position was still precarious and the economy was subject to a wide array of controls. Cole and Slade argue that the main reason for taking this action at that time was that the government could not exert effective control over foreign capital movements.

The removal of foreign exchange controls was preceded by drastic macroeconomic adjustment to eliminate fiscal deficits, restrict domestic credit expansion and counteract the hyperinflation and negative growth of the early to mid-1960s. However, the authorities imposed various financial controls after 1973 but without reversing the decision to keep an open capital account. The combination of credit ceilings on domestic banks with an open capital account caused a shift of much financial activity offshore. Domestic financial sector development stagnated and most industrial investment was financed in overseas markets.

Since 1983, the Indonesian authorities have pursued a policy of financial reform to stimulate the growth of the domestic financial system, still within the context of an open foreign exchange system. The program of reform involved the removal of credit ceilings and interest rate controls and was preceded by a major devaluation and fiscal retrenchment. The reform resulted in rapid growth of the banking system but exposed the economy to sudden shocks emanating from large falls of foreign exchange reserves and bouts of speculation about imminent devaluation. These were reinforced by a further major devaluation in 1986. However, the authorities took measures to stimulate the development of an active domestic money market to allow a more flexible response to changes in the financial position of the country. More recently the Indonesian authorities have taken steps to stimulate the growth of the capital markets and to open the financial system to greater competition from both domestic and foreign participants.

Cole and Slade note that the periods of high domestic financial growth were not correlated with the periods of high real growth. The initial period of financial growth between 1968 and 1972 occurred at a time when the economy was growing quite rapidly, but mainly due to recovery from a long period of mismanagement and deterioration. Then during the decade of high economic growth and high investment deriving from the oil boom, the domestic financial system languished. Finally, after the decline in oil prices, and real growth became more erratic, domestic financial development accelerated. Domestic financial

growth was influenced more by financial policy measures than by the overall growth of the economy.

A key question addressed by Cole and Slade is whether the Indonesian experience represents a special case of a country that had to follow a less than optimal sequence of reforms by force of circumstances and managed to succeed largely due to good luck or whether it represents a reasonable, or even better, sequence of financial reform. In their view, the open capital account has imposed a healthy degree of restraint on both fiscal and monetary policy. They note that an open capital account both incites and requires good macroeconomic management. For countries which are capable of pursuing reasonably sound macro policies, the Indonesian approach may be worthy of consideration.

### Financial Liberalization in Chile

The third paper on issues in financial liberalization focusses on the Chilean experience in the 1970s and early 1980s. **Hernan Cortes-Douglas** highlights the links between financial and other reforms in Chile, following the military coup in 1973 that overthrew the Allende government. Cortes-Douglas emphasizes the success of the reforms in the long-run and the extensive transformation of the Chilean economy and financial system over the past twenty years or so. He also stresses, however, the mistakes of the authorities in pursuing financial reform in the 1970s and underscores the conflict between opposing groups of policy makers on the importance of prudential regulation.

At the time of the 1973 coup, the Chilean economy was characterized by an oversized public sector, a very high rate of monetary expansion and inflation, extensive price and exchange controls, and excessive protectionism and regulation of industry, commerce, transportation and finance. The Pinochet regime proceeded to reduce public sector deficits and implement far-reaching reforms in trade, public enterprises and finance. The re-privatization of firms taken under public ownership by the Allende administration was a key element of early reforms. The prevailing philosophy was one of free markets with a minimal amount of regulation.

Credit ceilings, directed credit programs and interest rate controls were eliminated. Limits on foreign capital imports and foreign borrowing were also removed and access to such borrowing was encouraged by repeated pronouncements of the commitment to a fixed



nominal exchange rate. To facilitate the privatization process, the authorities encouraged access to bank credit by the new owners and allowed the formation of large conglomerates or grupos with interests in banking, insurance, industry and commerce. The groups bought banks on credit and used bank loans to buy privatized firms and to finance important investment projects and restructuring expenditures as well as real estate development projects and shopping malls in later years. The result was the creation of an excessively indebted private sector dominated by a few large conglomerates.

Cortes-Douglas underscores the differences of opinion among three opposing views within government ranks on the issue of financial reform. The predominant view was the "free banking" approach that downplayed the importance of prudential regulation and was against any involvement by the government in preventing bank failures. A second view emphasized the importance of prudential regulation and argued that the government should guarantee bank liabilities and regulate banks and other financial institutions to reduce the risk of failures. The third view was in favor of continued financial repression on the grounds that depositors should be protected but banks were difficult to control in a non-repressed environment.

Cortes-Douglas discusses three episodes of financial failure in the 1970s that exemplified the confusion and inconsistency of policies of financial reform. The first was the failure in 1975 of the Chilean savings and loan institutions. Following the free banking and minimalist approach, the government refused to cover their deposit liabilities, but forced their conversion into long-term bonds at less than par value. The second episode occurred in 1976 when in order to prevent a flight to quality by depositors, the government guaranteed the deposits of the Banco Osorno group. This represented a first but partial victory by advocates of prudential regulation. The third episode was that of Banco Espanol in 1980 when following the introduction of a loan classification system, auditors announced that on 37% of loans the bank lacked information to assess the borrowers' ability to repay their loans. Although Banco Espanol was originally rescued by a takeover from another large bank, it was one of four banks and four finance companies that were intervened in November 1981.

The financial crisis of 1982 was precipitated by a regulation that sought to drastically limit lending by group-owned banks to companies affiliated to the same group. The conglomerates were given no time to comply with the new rules, but were able to evade

them by creating many shell affiliates, swapping loans with other grupos and using mutual funds to replace bank loans. The crisis was triggered, however, by the rise in international real interest rates and the massive withdrawal of foreign funds following the devaluation of June 1982. When the crisis erupted, the authorities were forced to intervene and take over 60 per cent of the banking sector. They were also forced to change radically their approach and to make strong and effective prudential regulation the cornerstone of bank and financial regulation.

Since the 1982 crisis, the financial system has undergone major transformation and expansion. The banks have been successfully reprivatized and the insurance sector has been deregulated with a strong emphasis on solvency monitoring. The reform and replacement of the public pension system by a government mandated but privately operated system of individual capitalization accounts has contributed to the generation of large long-term savings and has stimulated the growth of the capital markets. Draconian rules have been imposed on the private pension funds to ensure their safety and protect the interests of their members. The Chilean authorities appear to have learned well the lesson that economic and financial liberalization must be accompanied by the creation of a strong and effective infrastructure of prudential regulation and supervision.

### **Banking Crises and Restructuring**

The Chilean experience shows that economic and financial liberalization without a proper framework of prudential regulation may lead to abuses of market power, conflicts of interest, and unsustainable and imprudent expansion. Such a process is bound to end in a major financial crisis that requires the intervention of the authorities to avert the complete collapse of the financial system. However, banking crises may also occur in countries that do not undergo major liberalization of their financial systems. The proximate causes of banking crisis may then be either a segment of the banking system that is not properly supervised and may engage in imprudent or fraudulent behavior or a segment that is subject to inconsistent regulations and to incentives that are incompatible with stable and sustained expansion. Another aspect of banking crises is the speed of reaction by the authorities to restructure ailing institutions, contain losses and remove the causes that brought about the crisis in the first place. Effective and speedy resolution mechanisms are essential for limiting losses and for avoiding the prolongation of the adverse effects of banking crises on the real economy.

### Banking Crisis in Malaysia

**Andrew Sheng** discusses the experience of Malaysia with banking crisis and restructuring in the mid-1980s. The Malaysian case is a prime example of decisive and effective action. In 1985 and 1986, the economy suffered from deflation as falling prices caused nominal GNP to decline more rapidly than real GNP. The financial system also suffered from steep falls in commodity, securities and property prices that had reached unsustainable levels following a long period of expansion and speculative investments in property and equities. With property loans accounting for 36% of all bank loans in 1986, up from 26% in 1980, commercial banks incurred heavy losses. In addition, finance companies and deposit taking cooperatives (DTCs) were heavily exposed to property investments.

Faced with a potentially major financial crisis and loss of confidence in the stability of the financial system, the authorities took decisive action to stem the losses, recapitalize distressed banks and intervene in institutions that were unable to inject new capital. Because the Malaysian monetary authorities had in place an effective system of banking supervision with stiff requirements for provisions against bad and doubtful debts and suspension of interest accrual, the impact of the recession and of the fall in commodity, securities and property prices on the big banks, though large in terms of reported losses, was contained by injections of fresh capital. Worst hit by the recession were four medium-size commercial banks that incurred heavy losses, particularly from their involvement in the property sector. The central bank intervened, replaced the management and board of directors of these banks and made arrangements for fresh injection of capital, including direct capital from the central bank itself. The central bank also had to assume control of four finance companies, which were unable to inject new capital to cover their losses.

The impact of the recession was much greater on DTCs, a group of institutions that accepted deposits from the public but were not supervised by the central bank and did not have access to its lender of last resort facilities. The first step here was to undertake a detailed investigation of affected institutions to establish the extent of losses. As Sheng notes, 17 accounting firms were employed to undertake, in conjunction with examiners from the central bank, detailed audits of 24 affected institutions. To assess public opinion on an appropriate rescue scheme, the government appointed a committee to find a restructuring plan that would be acceptable to all. The Committee recommended that DTCs with small

losses should be merged or taken over by financially strong banks and finance companies. For DTCs with large losses, the committee recommended that depositors should be offered a combination of cash and equity or convertible bonds. All DTCs were placed under central bank supervision, while to forestall law suits from jeopardizing the whole rescue package, receivers from accounting firms were appointed by the High Court to manage their assets.

Despite the long history of effective bank supervision, the authorities introduced key changes in banking laws and regulations to emphasize prudential safeguards, such as minimum capital requirements, dispersion of ownership, controls on connected lending, limits on risk concentrations, guidelines on provisions for loan losses and suspension of interest accrual on nonperforming loans, and improved statistical reporting to the central bank. In addition, the central bank was granted clearer intervention powers, including the right to enter and search offices, detain persons, impound passports, freeze property, issue cease and desist orders, and assume control of operations.

The Malaysian authorities were able to contain the banking crisis by taking prompt action to assess the extent of losses and address the problems of capital adequacy and competent management. With economic recovery resuming in 1987, the central bank was able to stabilize public confidence in the financial system and avoid the dangers of contagion spreading.

### Banking Crisis in Norway

In contrast to Malaysia, the Norwegian experience with financial liberalization and banking crisis has been one of prolonged distress and repeated interventions that culminated in the effective "nationalization" of virtually the whole banking system in 1991. To be fair, the Norwegian authorities did not lack in decisive action. As noted by Jon A. Solheim, they intervened to replace the management and board of directors of the DnC Bank in the spring of 1988, following heavy losses suffered after the collapse of securities markets in October 1987. They also arranged for mergers of institutions in distress, for capital injections and for extension of appropriate guarantees by the country's two bank guarantee funds, not to mention the provision of liquidity by the central bank. However, where the authorities proved lacking was perhaps in undertaking a thorough assessment of both the extent of losses suffered by banks and their exposure to firms in financial difficulty.

The problems faced by Norwegian banks have their roots in the extensive deregulation of Norwegian banking in the mid-1980s after a long period of tight restrictions, in the failure to introduce adequate prudential regulations, and in the unfortunate timing of deregulation with a period of strong, but unsustainable, expansion that was stimulated by large oil revenues. Macropolicy failures, such as the reluctance to raise the level of nominal interest rates and the delayed reduction of the tax deductibility of loan interest payments, resulted in a negative real after-tax cost of borrowing that stimulated the demand for bank loans and induced banks to compete for market share and disregard the soundness and long-term profitability of their lending.

When oil prices fell in 1986, the Norwegian economy suffered a major economic recession from which it has still to emerge. The banks incurred loan losses amounting to between 1.5-2.5% of loans each year. As a result, their capital has been seriously eroded and in some cases completely wiped out. Assistance was initially provided by the two guarantee funds operated by the commercial and savings banks respectively, but after the exhaustion of these funds, the government was forced to establish a government bank insurance fund to support the operations of ailing banks. The authorities are also encouraging an extensive process of consolidation and retrenchment and have created a new institution that will participate in new equity issues from private banks and help return sound banks to private ownership.

### The Thrift Debacle in the United States

While the Malaysian and Norwegian cases differ in the degree of success of government intervention, they both represent cases where banking problems were immediately recognized and prompt action was taken to tackle them. There are, however, many countries where governments have refused to recognize the existence of nonperforming loans and the mounting losses of banks. Among developed countries, a prime example of such attitude is the United States where the authorities have been very slow to appreciate the deteriorating financial condition of the savings and loan industry. As noted by Lawrence White, faced with large losses deriving from a negative interest margin in the early 1980s, savings and loan associations were authorized to diversify into other risky activities in the hope that profits from new activities could help rebuild their eroded capital.

White discusses the debacle of the US thrift industry in the context of its regulation and especially the accounting rules that applied on the measurement of its equity. He emphasizes the point that institutions with high leverage are inclined to engage in risky activities. This inclination is strengthened if depositors are protected by credible deposit insurance while prudential regulation and supervision is weak and ineffective. White stresses that since net worth and solvency are important concepts for prudential regulation, accounting rules should be designed to yield market values for assets, liabilities, and off-balance-sheet items. He notes that the accepted accounting framework is based on historic costs rather than current values, while special accounting rules were introduced for the thrifts that allowed them to overstate their net worth<sup>6</sup>.

The wider investment powers conferred on thrifts in combination with increased limits for deposit insurance, the use of brokered deposits, the overstatement of net worth and weakened thrift supervision encouraged many thrifts to undertake massive growth drives that in some cases resulted in a doubling or even quadrupling of their size within the space of three years. Many of the rapidly growing thrifts were controlled by new entrepreneurs, who were either inexperienced and overly aggressive or engaged in outright fraud. This unsustainable expansion was then made worse by the fall in oil prices, that affected in particular thrifts in oil producing states such as Texas, Oklahoma and Colorado, and radical changes in tax laws that first made commercial real estate a tax-favored investment and then reversed course and subjected real estate to less favorable tax treatment.

Faced with massive and growing losses from thrift insolvencies, the authorities were forced to seek additional funding for the disposal of insolvent thrifts and to transfer responsibility for regulating, supervising and disposing thrifts to three new federal agencies and the Federal Deposit Insurance Corporation that had previously provided deposit insurance for commercial banks. The U.S. experience shows that failure to perceive the extent of the thrift problem and a perverse regulatory reaction in the early 1980s caused what

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<sup>6</sup> White places strong emphasis on the use of market-value accounting. This is a view that is espoused by a growing number of economists but has yet to receive official backing. There are two problems with market-value accounting. First, it is difficult to assign market values to a wide range of assets and liabilities of financial institutions. Second, market values fluctuate widely and are depressed when capital is needed most. To be effective, market-value accounting must be accompanied by minimum capital ratios that vary procyclically with market values. Perhaps, market value accounting would not be necessary if financial institutions are allowed to diversify their risks and are not allowed to take excessive risks, especially interest rate risks.

could have been a manageable loss to magnify into a major debacle that is likely to exceed \$150 billion on a discounted present value basis.

## **Regulatory Framework for Banks and Other Financial Institutions**

The experience of Chile, Malaysia, Norway and the United States, reviewed in this volume, underscores the importance of an effective framework of prudential regulation and banking supervision. This is a theme that has received growing acceptance among policy makers in both developed and developing countries over the past decade or so. However, accepting a principle is not easily translated to successful action without a clear understanding of the necessary preconditions for such a framework and the essential changes in laws, regulations and procedures.

### **Prudential Regulation and Supervision of Banks**

Vincent Polizatto discusses these issues and reviews both alternative approaches used in different developed countries and the growing convergence towards a common system of prudential regulation and supervision. Polizatto states that prudential regulation is the codification of public policy for sound and stable banking systems, while banking supervision is the means of ensuring the banks' compliance with public policy. He emphasizes the importance of political independence of bank supervisors and the need for support from government officials at the highest levels.

The prudential rules that should apply to banks include clear rules on criteria for entry, capital adequacy standards, asset diversification, limits on loans to insiders, permissible range of activities, asset classification and provisioning, external audits, enforcement powers and failure resolution mechanisms. Criteria for entry should cover the minimum capital requirement, the qualifications of management, the development of reasonable business plans and projections, and the financial strength of the proposed owners. Capital adequacy standards should ideally include risk-based capital ratios that take account of the riskiness of different assets, both on and off the balance sheet. The guidelines formulated by the Basle Committee of Bank Supervisors are increasingly adopted by developing countries. Capital adequacy standards should also include a clear definition of different components of capital and should impose limits on the distribution of dividends if minimum standards are not met.

Banks achieve a better combination of risk and return by diversifying their operations. Thus, blanket restrictions on geographic expansion and product diversification should not be condoned by prudential regulations. But lending, investment and other exposure limits, which prevent the concentration of risk in a single borrower or a related group of borrowers, are necessary for prudential purposes. These limits should be expressed as a percentage of a bank's capital. A frequent cause of loan problems is credit granted to insiders and connected parties. Therefore, limits on loans to insiders, including large shareholders, and related companies, should be established. These should not only limit the amount of credit extended, but should also require that such credit should not benefit from more favorable terms and conditions than credit to ordinary customers. Prudential regulations should also stipulate whether banks can engage in commercial, industrial and nonbanking financial activities and whether they can own equity stakes in nonbanking firms. To discourage banks from assuming excessive risks, clear limits should be set on such activities, if they are permitted at all.

Polizatto argues that one of the most serious deficiencies of prudential regulation in developing countries is the failure to recognize problem assets through classification, provisioning, write off, and interest suspension. Prudential regulations should require banks to classify assets according to specific criteria, define nonperforming assets, suspend interest accrual on nonperforming assets (and reverse previously accrued but uncollected interest), preclude the refinancing or capitalization of interest, and mandate minimum provisions to the reserves for possible losses based on the classification of assets. External audits serve as a means to independently verify and disclose the financial position of banks. However, external audits must follow clear rules and procedures established by bank regulators and should include an examination of asset portfolio quality, standards for valuing assets, adequacy of loan loss reserves, and treatment of interest on nonperforming assets. Regulators should also have the power to appoint or dismiss auditors and should be informed of any significant findings in a timely manner.

A crucial aspect of prudential regulation regards the enforcement powers given to bank supervisors to intervene to prevent losses from magnifying and to effect timely resolutions of bank failures. Polizatto stresses the importance of conferring to bank supervisors the right to issue "cease and desist" orders, impose fines, appoint receivers, merge or liquidate banks, and generally play an active direct or indirect part in the management of ailing institutions.



Polizatto also reviews alternative models of bank supervision. He compares the informal system based on consultation, personal contact, discretion and moral suasion that traditionally prevailed in Britain in the past with the strongly populist and confrontational approach based on detailed "rules of the game" and intensive on-site examinations that prevailed in the United States. A third system, reflecting the experience of continental Europe, was based on a legalistic approach that stipulated various ratios but relied on external auditors for verifying compliance with the rules. Polizatto stresses the convergence in systems of prudential regulation (e.g. the adoption of the risk-weighted capital ratios based on the guidelines formulated by the Basle Committee) and in systems of bank supervision. Most countries now emphasize the complementary roles of off-site surveillance and on-site inspection. The former relies on the submission of regular reports, assessment of financial position and performance and peer reviews, while the latter involves detailed periodic examinations of bank records and policy statements.

Polizatto highlights the importance of recruiting able staff and training them to become specialized examiners as well as retaining experienced officers through appropriate compensation packages. He concludes his paper by stressing that the first line of defense against bank insolvencies and financial system distress is the quality and character of management within the banks themselves. Therefore, efforts to strengthen the financial system must also focus on building strong management.

### The Role of Deposit Insurance

Deposit insurance represents one of the most controversial elements of the prudential regulatory framework of banks. The greatest concern focusses on the risk of moral hazard that is inherent in almost any scheme of deposit insurance. There is much debate about the faults in the design of deposit insurance in the United States and its contribution to the debacle of the thrift industry and the current weakness of commercial banks. Many proposals have been made about the use of risk-based premiums, the effectiveness of supervision and the streamlining of failure resolution mechanisms, although the predominant experience is one of excessive encouragement of risk taking and excessive cost to taxpayers.

Deposit insurance may have four objectives: to protect small depositors; to avert generalized bank runs; to promote competition; and to act as a catalyst for strengthening bank supervision. The first objective is valid and widely accepted and is in fact applied to

all kinds of financial institutions (life insurance companies, mutual funds and even pension funds) and not just deposit institutions. The other three objectives are open to question. As discussed by Vittas<sup>7</sup>, structural controls that do not inhibit consolidation and do not encourage the emergence of fragmented and fragile banking systems may be more effective than the offer of deposit insurance both in averting bank panics and in promoting effective competition.

**Samuel Talley and Ignacio Mas** do not challenge the conventional wisdom on the objectives of deposit insurance. They argue, however, that the debate about the rationale for explicit deposit insurance misses the point that in most countries the real choice facing policy makers is not between explicit schemes and no protection but between explicit and implicit deposit protection schemes. Experience from most countries shows that except for very small banks, governments generally intervene to protect depositors in failed banks and prevent bank panics that might involve a flight to cash and real assets or a capital flight overseas.

Talley and Mas specify the features of two extreme types of deposit protection: an implicit protection system where there are no detailed rules and procedures, protection is completely discretionary, the amount of protection may vary from zero to total protection, there is no ex ante funding, and ex post funding is provided by the government; and an explicit insurance scheme where there are detailed rules and procedures, there is a legal obligation for protection (with some discretionary element for noninsured depositors), the amount of protection may vary from limited to total protection, there is ex ante funding through premiums, and failures are covered by the fund, although additional assessments may be levied on banks or government contributions may be made.

Talley and Mas stress that explicit schemes have both advantages and disadvantages over implicit ones. They constitute a better administrative process for resolving bank failures and are more effective in protecting small depositors. On the other hand, they are less flexible than implicit schemes, which enjoy greater degrees of freedom in terms of the amount, form and timing of the protection offered. Talley and Mas note that both types of schemes are exposed to moral hazard, but they stress that explicit schemes presuppose stable banking systems, effective prudential regulation and banking supervision, and adequate

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<sup>7</sup> See Chapter 3.

funding sources. The treatment of banks varies between the two schemes. If the government (or the central bank) assumes the costs of bank failures under an implicit system, then the banking system derives a large subsidy. In practice, however, banks are made to pay either through increased taxes (e.g. increased reserve requirements) or through induced participation in takeovers of failed banks, where the costs are shared between the bank involved and the authorities.

Talley and Mas also examine a number of important features of explicit deposit insurance systems. These include the choice between public and private as well as between compulsory and voluntary systems, the amount of protection (which may vary from limited, total and discretionary), the role of prefunding, the base of premium assessment and use of fixed or risk-based premiums, and the design of failure resolution mechanisms. In general, Talley and Mas favor compulsory, public systems, with limited but discretionary protection, adequate prefunding, risk-based premiums and effective resolution mechanisms. However, they stress that the design of national deposit insurance schemes must be effected on a case-by-case basis to take account of local circumstances.

### The Regulation of Life Insurance Companies

The financial systems of most developing countries continue to be dominated by commercial banks. With few exceptions, insurance companies and pension funds account for small and insignificant shares of total financial assets. The main reasons for the underdevelopment of contractual savings institutions are the low level of income, the existence of pay-as-you-go public pension systems, the imposition of repressive regulations and the use of insurance and pension reserves for financing the public sector deficit at below market rates.

Contractual savings institutions are more developed in those countries that impose mandatory funded schemes for pensions such as Singapore, Malaysia and Chile. In fact, the organization of a country's pension system is nowadays a major determinant of financial structure, not only in developing countries but also in developed ones<sup>8</sup>. However, the regulation of insurance business, and especially life insurance, is also an important factor.

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<sup>8</sup> For a brief discussion of these points, see Vittas (1992).

Insurance regulation has traditionally followed two distinct approaches. One approach has emphasized the fixing of premiums at levels that are adequate to pay future claims and avoid insolvencies. The other approach is based on solvency monitoring. It avoids tariff setting but requires the maintenance of adequate technical reserves and capital resources for ensuring the solvency of insurance companies. The two approaches are not mutually exclusive. For instance, solvency margins are emphasized in countries where premiums are fixed centrally, while solvency monitoring has implications for premium setting by insurance companies. It is generally agreed that the first system of regulation achieves greater stability, but at the cost of higher prices and limited innovation. However, both systems face difficult issues in regulating distribution networks and selling techniques.

**Thomas Rabe** discusses the regulation of life insurance companies in the United Kingdom and Germany. He notes that in Germany policy conditions are subject to approval by supervisory authorities in order to prevent the offer of "deceptive" packages. The supervisory authority also approves the basic elements of premium calculation, such as mortality tables, discount rate and loadings. The result of this approach is to discourage innovation (unit-linked life policies account for a very small share of total business in Germany) and to encourage high initial premiums that are then partly rebated to policyholders. In contrast, UK life insurance companies enjoy considerable freedom in both product innovation and premium setting. It is generally claimed that life policies are cheaper in the United Kingdom, especially for shorter terms.

Rabe notes that there are also substantial differences in the regulation of investments. In Germany, regulations limit the freedom of investment by specifying the range of permitted assets. Although the German authorities avoid the use of investment regulations for directing insurance funds into low-yielding securities, the imposed limits discourage investments in corporate equities and overseas assets. In the United Kingdom, insurance companies are not subject to any regulations on their investments, except that valuation rules specify upper limits on assets that are admissible in calculating technical reserves and solvency margins.

There is a substantial difference in the valuation of assets. In Germany, companies must use, in most cases, the lower of cost or current value. Unrealized investment gains may not be taken into the profit and loss account and cannot be distributed. Thus, like banks, German insurance companies have considerable hidden reserves. In the United Kingdom, companies are free to use market value, historic cost or a value between the two.

However, in statutory returns, assets must be shown at market values. Unrealized gains are commonly taken into the profit and loss, although it is the responsibility of the appointed actuary to determine which portion of unrealized gains can be distributed.

With regard to distribution networks, Rabe notes that there is no regulation on the selling and marketing of life insurance in Germany. As a result, most selling is effected through tied agents and companies tend to mount lavish and aggressive campaigns that raise commissions and other selling costs. In the United Kingdom, there is regulatory distinction between tied agents and independent brokers (polarization). Tied agents sell products of one life office. In contrast, independent brokers are required to offer best advice. Because of the stringent standards, 50% of independent brokers have decided to become tied agents. The sale of life insurance products is still a controversial issue in the United Kingdom, as in most other countries. Insurance companies emphasize that insurance business is not bought and has to be sold, but there is widespread concern that customers are pushed to buy policies they do not need. It is estimated that 40% of long-term life policies are allowed to lapse after two years, at great expense to policyholders. Rabe concludes the comparison of regulatory regimes between the two countries by noting that in Germany there are no compensation or guarantee funds on the grounds that the state ensures that no insurance insolvency will ever be allowed to take place. In the United Kingdom, where regulation is less pervasive, compensation funds cover up to 90% of insured amounts in cases of insolvency.

Rabe also discusses the trend toward deregulation that is under way in most continental European countries and the policy of the European Commission to create a single market in insurance. The objectives of the single market include freedom of establishment in any member country, freedom of cross-border operations, use of the same key supervisory rules regarding solvency, reserving, guarantee funds, investments and policy design, and similar controls over selling methods and distribution networks. An important feature is the elimination of premium controls and their replacement with solvency margins that take account of both premium levels and loss experience. In this way, deceptive packages may be avoided without stringent controls on prices and product innovation.

The initiatives taken by member states of the European Community have had a tremendous impact on insurance regulation in many other countries. Not only other European countries, including those in Eastern Europe, but also countries in Latin America,

North Africa and Asia have reformed or are contemplating reforms of their insurance legislation in line with the main principles adopted at the EC level.

### **Regulatory Issues in Integrated Financial Systems**

The financial systems of many countries have been characterized by a number of major trends that have been described by long and ugly words. These are difficult to pronounce, and even more so to spell, but the trends are no less real for that. The trends can be usefully classified into pairs:

- Liberalization and deregulation
- Internationalization and globalization
- Securitization and marketization
- Privatization and demutualization
- Universalization and institutionalization
- Decompartmentalization and integration

These trends reflect changes in both structure and behavior and have far reaching implications for the stability, efficiency and fairness of financial systems. They have been accompanied by a development that can be described as paradoxical: growing concentration of markets through an extensive consolidation process, but also growing competition through the removal of boundaries that used to separate different markets.

Unfortunately, theoretical and empirical economic work has shed little light on the benefits and costs of alternative arrangements of financial system structure. The vast literature on economies of scale and scope in banking has been unable to explain the persistent increase in concentration. Universal banking and integrated financial systems raise far more complex issues and it is not surprising that there is a greater difference of opinion among economists on the merits and demerits of universal banks than there is perhaps on the existence of economies of scale and scope.

#### **Universal Banking in Canada**

Universal banking has been extensively debated in many countries in recent years, but perhaps nowhere as thoroughly and openly as in Canada. **Charles Freedman** reviews the

arguments for and against universal banking and discusses the rationale for the solutions adopted in Canada. Freedman notes that there are two principal uses of the term universal banking: one definition refers to the ability of banks to engage in securities business; the other to their ability to own and control nonfinancial entities. Banks in Canada are primarily interested in underwriting corporate bonds and equities, and not in owning and controlling industrial and commercial companies. The narrow definition is, therefore, more appropriate in the Canadian context.

Freedman also draws a clear distinction between upstream and downstream linkages between banks and nonfinancial corporations. Upstream linkages exist when nonfinancial companies own and control banks, downstream linkages when banks own and control nonfinancial corporations. Upstream linkages generally give rise to greater concern among policy makers and regulators.

The Canadian financial system has traditionally been compartmentalized by function between chartered banks, trust and mortgage loan companies, cooperative credit institutions, insurance companies and securities dealers. Most of the largest institutions have been widely held, either because it has been required by law as in the case of the big chartered banks (known as schedule I banks) or because they have been constituted as mutual entities (as in the case of credit cooperatives and some of the largest life insurance companies). However, some large trust companies have recently come under close ownership as parts of industrial and commercial conglomerates. Regulatory responsibility has been divided between the federal and provincial governments, with sole federal government responsibility for banks, sole provincial responsibility for credit cooperatives and securities dealers, and dual (federal and provincial) responsibility for trust and insurance companies.

The traditional separation of functions has been blurring over the past twenty five years or so: banks have expanded into consumer credit and mortgage finance; trust companies, credit cooperatives and securities dealers into payment services; trust companies into consumer credit and even commercial lending; insurance companies into savings instruments, such as single premium deferred annuities that closely resemble fixed-term deposits; commercial banks into various forms of insurance; etc. The blurring of demarcation lines, the need to create a level playing field for all financial institutions and to establish a sound and robust regulatory framework, and the competitive impact from developments in overseas markets have prompted the Canadian authorities to consider

legislative changes with far-reaching implications for the structure and functioning of the Canadian financial system.

Freedman addresses the issues of ownership, self dealing, conflicts of interest and corporate governance that are at the heart of the debate about integrated financial systems. He notes that although the ownership issue has been the most contentious one, the authorities have concluded that large banks and insurance companies should continue to be widely held but smaller financial institutions could be closely-held and commercially-linked. On self dealing there is widespread agreement on the need to impose strict limits on transactions with related parties. Conflicts of interest could be handled through better information disclosure, establishment of effective monitoring machinery and a reliance on reputational considerations that would prevent banks and other financial institutions from abusing privileged information. Strengthening of the functioning of boards of directors and of the role of external auditors would be two essential elements of tackling corporate governance issues.

Freedman then discusses the impact of the 1987 change in legislation that allowed commercial banks and other financial institutions to acquire securities firms. He considers three rationales for the legal separation of banking and securities business: the assumption of excessive risks by banks and its impact on deposit insurance; the potential conflicts of interest between bank lending and underwriting; and the concentration of financial power. He notes that banks in Canada are not permitted to engage in trust business, but otherwise the traditional separation between banks and securities business was based on custom rather than legislation. In contrast, in the United States, there is a legal separation between commercial and investment banking, but commercial banks are allowed to engage in trust business. These contradictions reflect historical accidents but clearly weaken the rationale for enforced separation. In Canada, factors motivating change included the growth of syndicated lending, the advent of securitization of corporate financing business and the need for increased capital by securities dealers. Following the change in securities legislation in 1987, Canadian banks, both domestic and foreign (but not insurance or trust companies) entered the securities industry, mostly by acquiring existing securities firms. There was also an influx of several foreign dealers.

As noted in Chapter 13, Freedman's paper was completed before the latest legislative developments. In fact, following a long process of debate and consultation, the Canadian government adopted on December 13, 1991 (date of Royal Assent) a new regulatory



framework for all financial institutions, consisting of four new acts governing banks, trust and loan companies, financial cooperative associations and insurance companies. The new financial services legislation will come into force sometime in 1992.

Recognizing the unavoidable integration of financial services, the new regime enables every institution to offer a complete range of financial services, in many instances through subsidiaries. The expression "financial services" is not defined, thus providing flexibility to expand and adjust to a fast-changing environment both in Canada and abroad. An important feature of the new legislation is its high degree of standardization of rules applicable to different types of institutions. Thus, new banks, insurance companies and trust companies will be incorporated in the same way. The rules governing related-party transactions, directors' liability, board composition, shareholdings, insider trading and the role of external auditors are common to all and are, for the most part, identical. With respect to permitted in-house activities, financial institutions are confined to the provision of financial services. Banks will be barred from insuring risks, issuing life annuities and acting as insurance agents. Insurance companies will be able to do everything banks do except take deposits.

Insurance companies and banks will be unable to engage in trust business or in underwriting corporate bonds and equities. The former activity remains the exclusive function of trust companies, while the latter belongs to securities firms. However, banks and insurance companies will be able to own subsidiaries specializing in these and other areas, including each other's area of expertise. The list of permitted subsidiaries is quite long and effectively open-ended. For instance, banks are allowed to own insurance, reinsurance, trust, loan, securities, investment (mutual) fund, venture capital, factoring, equipment leasing and financial holding companies as well as any entities which primarily provide financial services. There is no requirement for specialized subsidiaries to be organized through a holding company structure.

Thus, the Canadian system has not only adopted the concept of universal banking but has also authorized the emergence of "allfinanz" or "hancassurance", which refers to the marriage of banking and insurance and is spreading rapidly in Europe. One limitation that applies on banks and represents a political concession to insurance agents is that banks will not be allowed to sell insurance products through their branches, nor to use their large customer databases for insurance marketing purposes. However, use of credit card

distribution networks is permitted so that this restriction may turn out to be less binding in practice.

### The Debate on Financial Conglomerates in Italy

An intense debate has been going on in Italy for several years on the merits and demerits of universal banking and linkages between banks and industrial companies. As noted by **Mario Draghi**, after a long period of regulation and sheltered existence, Italian banks have been faced with a pressing need for restructuring and recapitalization. Unlike Canada, where the benefits and costs of upstream linkages were at the periphery of the debate, the Italian debate has focussed on whether the necessary structural changes can be achieved by the banking sector alone or whether they need the participation of the industrial sector, which has restructured itself with astonishing success.

Draghi reviews the arguments for and against such linkages in the context of past and recent developments in Italian banking and the changes in EEC legislation that are prompted by the creation of the single European market. He provides a brief historical review of the experience of universal banking in Italy before the 1930s. The failures of that era led to the establishment of a rigidly controlled system that imposed a clear separation between short and long-term business, between commercial and investment banking, and between banking and industry. It also led to the public ownership of large commercial banks that co-existed with a number of public law banks and savings banks and dominated the Italian financial system.

Draghi discusses the merits and demerits of both universal banking and upstream linkages. He cautions that universal banking, which appears to have been quite successful in Germany, would not necessarily be equally successful if it was transplanted into other countries. He places particular emphasis on the conflicts of interest inherent in a universal banking system and on the difficulty of monitoring and controlling the behavior of universal banks.

Draghi also notes that leaders of large industrial conglomerates have exerted considerable pressure for the right to acquire controlling stakes in banking institutions. The main arguments in favor of upstream linkages are the provision of private capital and the potential transfer of strong management skills. The main arguments against are the potential

excessive concentration of power, the large conflicts of interest and the burden on monitoring and surveillance for preventing abuse of privileged information.

Draghi then discusses the legislative changes prompted by the creation of the single European market and the passing of the Second Banking Directive of the EEC. He notes that the banking directive provides for the authorization of universal banks with extensive powers, subject to various risk concentration limits, but does not preclude nonbanks from having controlling interests in banks. The EEC directive does not prevent national authorities from imposing stricter rules on national banks but, as Draghi emphasizes, more restrictive rules would undermine the competitive position of national institutions.

Draghi reviews the recent legislative changes, especially the provisions of the so-called Amato Law, and their impact on the Italian banking structure. The new law covers the merger, transformation and recapitalization of Italian banks and improvements in bank supervision. The law authorizes public law banks to convert themselves into corporations. Although it does not promote bank privatization as such, it states that privatization may be authorized if it is instrumental in strengthening the Italian banking system, increases its capital, and meets public interest goals. However, it imposes strict conditions, such as requiring the approval of both the Bank of Italy and the Council of Ministers and provisions that preclude control of privatized banks by nonbanks or by individuals.

The Amato Law in combination with new anti-trust legislation impose clear limits on upstream linkages and require the creation of holding company structures for undertaking the various financial activities authorized by the second directive. Following the enactment of these laws and other changes in regulations, Italian banking has undergone considerable restructuring. There have been several important bank mergers, public law banks have changed their status into corporations and have floated new equity on the markets, and freed from branching restrictions, banks have proceeded to more than double their branch networks. Banks have also established specialized securities firms. However, Italian banking legislation is likely to undergo further radical change in the near future in order to bring it into line with EEC developments.

## **The Role of Holding Company Structures**

Despite reservations about excessive risks and concentration of power, universal banking has been adopted by most OECD countries as well as a growing number of developing countries, especially in Latin America and Eastern Europe. The two major countries, where universal banking is not yet fully authorized, are Japan and the United States. In Japan, the existence of keiretsu conglomerates with strong links between banks, insurance companies and other financial institutions (as well as industrial companies) has effectively created universal financial institutions. In the United States, the current administration proposed a radical reform of banking legislation that would have removed the legal separation between commercial and investment banking, banking and insurance, and banking and commerce. However, the proposed reform did not win congressional support.

While approving universal banking, most countries have imposed limits on upstream linkages that would prevent industrial and commercial companies from controlling financial institutions, especially large banks and insurance companies. The one question that remains unresolved regards the structure of universal banking operations. In the United States, the holding company structure has been proposed and actively considered as a better structure for conducting universal banking. In a holding company structure, nonbanking activities are undertaken by subsidiaries of a parent holding company rather than by subsidiaries of the bank.

The arguments for and against the holding company structure are reviewed by Samuel Talley. Talley notes that proponents of the holding company structure argue that it would allow the public to derive the benefits of universal banking without placing the stability of the system in jeopardy. This is because clear limitations would be placed on transactions between the bank, its parent company and its other subsidiaries. For instance, any transactions would have to be effected on market terms. In addition, the holding company structure would create a level playing field for both banking and nonbanking competitors, while the bank would be protected from risky activities that would be undertaken by nonbanking subsidiaries.

Talley notes, however, that in practice it may be difficult to insulate banks from holding company problems. The "corporate veil" may be pierced if the group is perceived as one entity by the courts, if problems at the holding company level affect confidence in the

soundness of the bank, and if holding company problems lead to adverse transactions with the bank in violation of existing "firewall" rules. Talley also notes that there is limited evidence in the United States against the insulation view.

Two ways in which a holding company structure can avoid problems is by creating a fail-proof bank (also known as "narrow" bank) and by creating a fail-proof parent. The fail-proof bank proposal would force banks to separate their traditional deposit and lending functions. Banks accepting deposits from the public would be confined to investing in risk-free assets, such as treasury bills or perhaps high quality commercial paper. Talley notes that this proposal has considerable theoretical merit, but would require a wrenching change in the structure and operation of the banking and financial system. A basic problem would likely be that the amount of liquid bank deposits would greatly exceed the supply of risk-free assets.

The fail-proof parent proposal would require all risky activities to be conducted in nonbank subsidiaries, thus insulating both bank and the parent company from problems at the subsidiary level. Under this proposal, the parent company would not be allowed to issue debt, while the bank would not be allowed to engage in most types of transactions with either the parent company or its nonbank subsidiaries. Talley argues that the fail-proof parent proposal has many advantages over the other proposals in that it would provide greater protection to the bank and would create a level playing field for different types of activities.

### **Concluding Remarks**

What conclusions could be drawn from this overview of issues in financial regulation? The first point, which cannot be overemphasized, is that the 1980s was not a decade of deregulation, but rather a period of extensive regulatory reform. There was decreased reliance on economic regulations that inhibit competition, innovation and efficiency but an increasing importance of prudential and other regulations that promote stability and fairness.

Second, there is now widespread consensus that macroeconomic and allocative regulations may be justified under special circumstances, but that over time there should be greater reliance on market mechanisms for monetary and credit control and for allocating scarce financial resources.

Third, a question that is still open concerns the speed and sequence of financial reforms. The contrasting experiences of Japan and Chile support a cautious and gradual approach. Abrupt liberalization after a long period of repressive control may be quite dangerous - Chile had negative interest rates at least from 1945 to 1973. The experience of Indonesia also confirms that caution is important but suggests that there may not exist a unique and optimal sequence of reforms.

Fourth, there is very strong consensus on the importance of prudential, organizational and protective controls. Although particular types of control, such as the Basle risk-weighted capital ratios, are sometimes questioned, there is little disagreement on the need for capital adequacy and for strong banking supervision. However, because of their greater uncertainty and risks facing banks in developing countries, they should perhaps be subject to higher capital ratios than those recommended under the Basle agreement.

Fifth, there is ample recognition of the importance of speedy and decisive intervention to prevent insolvent institutions from magnifying losses. This is underscored by the experience of banking crisis and restructuring in Malaysia, Norway and the United States.

Sixth, the role of deposit insurance is still unclear. It is instrumental in protecting small savers, but otherwise its role in preventing bank runs, promoting competition or stimulating better regulatory mechanisms is open to serious objections. Deposit insurance suffers from a high risk of moral hazard.

Seventh, the regulatory issues of nonbank financial intermediaries are very similar to those of banks. For life insurance companies, price and product controls, which inhibit competition, are being replaced by solvency controls. In addition, the use of insurance (and pension) funds for financing large public sector debts at below-market yields is being replaced by investment rules that emphasize safety and profitability.

Eighth, the most controversial type of controls are still structural controls that impose geographic or functional limitations on the activities of financial institutions. There is general agreement against geographic restrictions, especially for institutions operating in areas with a common currency. There is also a worldwide trend in favor of universal banking and even in favor of close links between banks and insurance, but there is generally less support for close links between banks and industrial companies. This is particularly so

for upstream linkages that involve industrial companies owning or controlling large banks and insurance companies.

Ninth, it is widely accepted that universal institutions pose a serious challenge on regulators and supervisors. Countries with weak supervisory agencies would be well advised to promote simpler and more transparent structures, at least until they are able to strengthen their regulatory and supervisory mechanisms.

Tenth, despite the worldwide trend towards universal banking, there is considerable controversy regarding the desirability and benefits of this trend. Many analysts emphasize the difficulties of regulation by function and reliance on conduct rules for overcoming excessive risk taking, conflicts of interest and abuse of privileged information. These analysts favor structural controls that limit the scope for fraud and mismanagement. But other analysts argue that the threat of regulation, reputational considerations and provisions for legal redress against offending institutions would be effective in policing universal institutions.

#### Is There a Role for Portfolio and Growth Limits?

Despite the acknowledged importance of prudential regulations, no country appears to have developed a robust regulatory framework. Banks and other financial institutions in a large and growing number of countries have suffered from excessive risk taking, mismanagement and fraud. Capital adequacy controls and greater supervision have not succeeded in preventing large losses and failures, although it is fair to say that few countries, if any, have fully and consistently implemented such controls. At the time of writing this chapter, most Anglo-American and Scandinavian countries that have implemented extensive financial deregulation in the 1980s suffer from the consequences of excessive and uncritical expansion of credit as well as from widespread mismanagement and a significant amount of fraud.

One school of thought attributes the phenomenon of large and widespread financial failures in part to a lack of experience and expertise. Mistakes have been made because, after a long period of tight regulation, banks and other financial institutions have failed to

develop adequate internal systems of controls. According to this view<sup>9</sup>, financial failures will decline in frequency as well as intensity once institutions learn how to operate and compete in the new deregulated environment. To some extent, excesses occurred because prudential regulation and supervision were ineffective. Not only were incentive structures distorted in favor of risk taking, but they failed to reward monitoring and risk assessment. Strengthening supervision and correcting the structure of incentives would minimize the likelihood of a repetition of these mistakes in the future.

An alternative view is that there is a systemic tendency of financial institutions to engage in destructive competition, to assume excessive risks and to engage in imprudent and/or fraudulent activities. According to this view, the performance and behavior of financial institutions in the 1980s bears close resemblance to the 1920s. Without the stabilizing influence of deposit insurance and governmental readiness to provide financial support to avert financial panics, the world economy might have experienced the financial collapse and destruction of the Great Depression. Although macrofinancial controls for development purposes have clearly lost their traditional appeal, there may be some argument for imposing stricter portfolio limits and especially growth limits for purely prudential purposes.

The rationale for such types of controls would rest on two arguments: first, the need to ensure adequate risk diversification; and second, the need to ensure a smooth and reasonably sustainable expansion of business. In the United States, existing prudential controls, such as risk-based capital ratios and limits on individual risk concentrations, failed to address problems caused by high concentrations of portfolio risks. In fact, many deposit institutions suffered from excessive concentration of risks. In Texas, Colorado and other states, this was caused by restrictions on interstate expansion, but in New England, where geographic restrictions were less binding, the banking sector had 48% of its total loan portfolio in real-estate-related loans in 1990. Portfolio limits would prevent this problem or at least they could require a higher capital backing for higher levels of portfolio risks. Portfolio limits would, of course, need to take care of any covariance of risks between different types of loans<sup>10</sup>. Moreover, their introduction and subsequent revision would have

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<sup>9</sup> See Caprio and Atiyas (forthcoming 1992).

<sup>10</sup> For instance, in Texas, where energy lending accounted for a big part of bank lending, banks diversified their loan portfolios by engaging in real estate lending, despite the fact that the



to be implemented gradually to avoid big distortions in the flow of credit to particular sectors.

The rationale for placing limits on bank growth stems from the argument that fast growing institutions tend to suffer from managerial problems. Rapid expansion stretches management information and control systems<sup>11</sup>. Growth limits that would apply on an annual as well as a longer time framework could provide sufficient flexibility to individual institutions<sup>12</sup>, while ensuring that a spurt of rapid growth was followed by a period of consolidation before resuming a fast pace of growth.

How portfolio and growth limits could be applied without inhibiting competition and undermining efficiency remains unclear. However, it is an issue that is still open and could be revisited if more traditional controls fail to promote efficient, fair and above all stable systems.

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two sectors were highly interdependent. When the oil price collapsed, loan losses were high on both types of loans.

<sup>11</sup> Research at the Federal Reserve Board identifies rapid growth as the most consistent predictor of future bank trouble.

<sup>12</sup> Growth regulations could, for instance, impose a 15% annual limit (presumably, in real terms) and a 50% cumulative rate over 5 years. As reported by White (see Chapter 9), some savings and loan associations grew in the United States by 200% and 400% over the space of three years or less.

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